How to find the right investors for your business

The three critical stages of development—startup, incubation, and growth—call for three different sources of funding.

Now that you've written your business plan and lined up one or two key founders, the next step is to raise enough money to get going. In this article, the sixth in our Business Engineering series, I'll try to answer some of your questions about raising money for the three critical stages of your business development: getting started, incubating your first product, and implementing a plan for orderly growth.

The most important advice I can share with you is to take money only from people who have confidence in you. Let me put that even more strongly: you must not take money from anyone unless both sides are totally comfortable with each other. Since investors are really part of the team, the need for mutual trust and confidence in your working relationships is as important here as it is in building an organization (see ***Laser Focus World***, July 1995, p. 61).

Before deciding how to finance your company, you want to establish your personal goals and think about how you will repay investors for taking the risk. Remember, once you take on shareholders (investors or partners), the company is no longer your own. For ethical and legal reasons, you must put the interests of minority shareholders before your own, however small their investment might be.

Professional investors specialize to minimize risk, and they develop different paradigms based on their own circumstances. You can waste a lot of time dealing with investors who wouldn't invest in your kind of company anyway because it doesn't fit their profile with respect to size or risk/reward. So you want to target the right kind of investors and then learn everything about them so you can work with them effectively.

You'll have a better chance of interacting productively and negotiating successfully if you can look at the situation from the other person's point of view. You'll want to understand not only the opportunities investors look for, but also the particular problems they face. Banks, for example, almost never take risks because they typically make only 1 % profit on their loans. You may want to establish how much risk you're willing to assume before talking to a banker. Even venture capitalists rarely venture outside the particular range of target companies in which they invest. They follow strict guidelines, some of which are established when the partnerships are formed.

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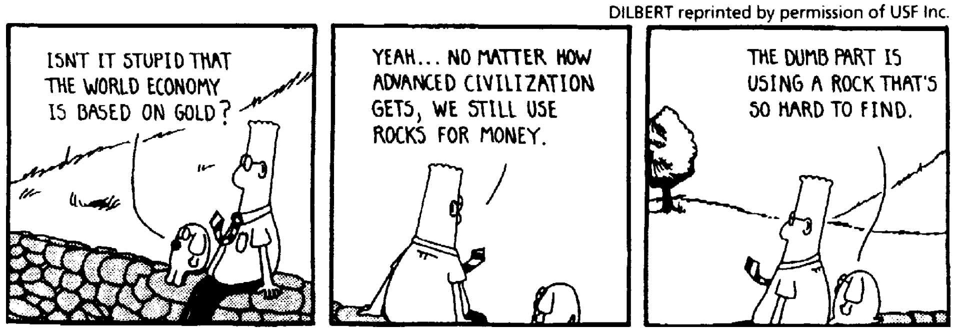

Funding the startup stage

Let's assume your projection of startup costs shows you need $50,000 to demonstrate proof of principle. Investment money is very expensive at this stage because the risks are high when all you have is an idea.

The founders should do everything possible to fund the startup stage themselves. The company has a better chance of success if the people with the greatest day-to-day responsibility also have the greatest incentive to succeed. You'd be amazed how far you can stretch a dollar when you're strapped for cash. You become very resourceful; for example, you might borrow test equipment or ask for free samples. People are usually happy to help.

If the founders are contributing a portion of the $50,000, try to arrange the combination of "sweat equity" and cash investment so that later, when the company is successful, the distribution of ownership will be consistent with the role of each person. You can base the price of the stock on fair market value determined by what outside investors are willing to pay. To determine the value of sweat equity, subtract what you get paid during startup from what you could have made on the open market.

You may also consider accepting investments from friends and relatives at this stage. Conventional wisdom says that's a bad idea because you stand to lose a friend if your business fails. But if you present your opportunity objectively, state the risks clearly up front, and remain open and honest throughout, your relationship will probably endure, and it may even be strengthened. It is actually more important for you not to take it personally when they turn you down. Keep in mind also that most friends and relatives have limited resources and are not professional investors — they can't help you out in future rounds of financing as professional investors can.

Funding the incubation stage

Once you've proven that your idea is sound, you will want to raise money to build a prototype and get a few working models into customers' hands. You'll also want to begin paying the founders a small salary and to hire one or two people with administrative or additional technical skills. The big issues to resolve now are how much money you need, where you can get it, and how much of your company to give UP to your investors.

A detailed projection of how you expect the business to develop will give you the most accurate numbers, An investor's rule of thumb is $100,000 per person, assuming the group is composed mostly of engineers. That amount would cover their salaries and benefits and support their ongoing activities. Let's assume you now want to raise $250,000; giving up 15%-35% is a reasonable starting point (See "Determining your company's worth," below).

Chances are this amount would be beyond the scope of the founders and their friends and relatives but not large enough to interest venture capitalists. Private investors, referred to as "angels" in the financial community, are a good source of funding for this level. Angels are often wealthy individual investors who dabble in high-risk startups after building successful businesses themselves. These people are optimistic. They can identify with what you do, help you by sharing their experiences, and give you credibility in raising additional capital. Some of them are even willing to combine their equity investment with a loan, thereby allowing you to retain a bigger portion of the company. You can ask your lawyer, banker, accountant, and anybody else you know for introductions. Some investment brokers can help you find these individuals, but as a rule you want to be extremely selective because most investors resent paying a broker's commission.

Large companies rarely invest in small companies unless the strategic reasons are overwhelming. Strategic issues usually mandate some restrictions on what the company can do later on, and the deal usually includes an option to acquire the company. On the positive side, investment from big companies can give you credibility, and the companies usually have deep pockets.

Government contracts, too, can supplement your research and development expenditure and help you raise money by giving you credibility. Since R&D expenses come out of profits for an operating company, every contract dollar you get means one less dollar you have to earn or fewer shares you have to give up to an investor. However, it's essential that you limit yourself to contracts that fit into your long-term product strategies and that these products do not face "window to market" concerns. You may experience delays and uncertainty in funding, and the allowable profit is only a few percent of the contract amount. You will be using up brainpower, your most valuable asset, for a small profit if your work doesn't lead to any product or create a capability that can lead to products.

Funding the growth stage

At this point, your products have been well received, and you've developed a good feel for their market potential. Professionals are joining you to manage day-to-day activities, ship products, and build the business infrastructure you need to achieve orderly growth. That's good news, but now you need money to ramp up.

The amount of money you need depends on how fast you want to grow. You can work through several scenarios for growing the business and optimize the tradeoff between how much you give up and what you get at the end. In working through the details, be creative about ways to stretch your capital. In some cases, customers are willing to pay in advance when placing the order, suppliers are willing to stretch out payments, and government agencies are willing to pay within ten days with only a small prompt-payment discount. In today's environment, a high-tech business can rarely become self-sufficient with less than $1 million of investment in the growth phase, and it can certainly require a lot more.

Venture capitalists are your most likely source of funding at this stage. They prefer investing in companies that can gain liquidity quickly. To simplify their decision-making process, they tend to specialize and to work with other venture capitalists in teams.

You'll need an experienced adviser on your side of the negotiations. Remember, venture capitalists are used to dealing with entrepreneurs, but this is probably your first experience in dealing with them. Don't expect them to make decisions quickly. They follow a rigorous procedure, and they understand that time translates into more options for

Determining your company's worth

The investor is buying a portion of your company. How much ownership he or she gets for the investment depends on the valuation of the company. That figure is not just a simple addition of what the company is worth today plus the investment input. Investors try to forecast what their holdings will be worth when they cash out, then work backwards to see how low the present valuation must be to give them an acceptable rate Of return.

Valuation is highly subjective and can vary significantly with time and place, depending on what is popular with investors at the time. You'll want to consult knowledgeable people when establishing a valuation so you present your company in the best light. Professional investors often resort to "comps," or comparisons to investments of a similar nature. For example, if you supply optics for multimedia applications, you could compare your company to other optics companies or to other multimedia companies and come up with two quite different valuations. By evaluating an investment in several different ways, you can derive a self-consistent number. Rarely can you increase the valuation substantially by haggling or strong-handed negotiations. And don't nickel and dime potential investors; take the money and get going. This isn't your last deal.

Remember, also, you want to keep the process pleasant so that you can work with each other afterwards. Most likely an investor will demand at least one seat on your board of directors, so you'll want to choose a person you can work with and learn from, even if someone obnoxious is willing to pay more.

Sizing up risks: an investor's checklist

People-quality risks

CEO quality: ◊ ineffective ◊ unproven ◊ professional ◊ done it before
Business team: ◊ glaring problems ◊ big recruiting job ◊ one open slot ◊ full professional team
Investors: ◊ problem investors ◊ weak acceptable ◊ top-tier firms
Board quality: ◊ problems ◊ fixable ◊ professional ◊ ideal

Financing risks

Additional capital needed: ◊ >$10 million ◊ $5 million-$10 million ◊ <$5 million zero
Investor group appetite: ◊ no $ available ◊ tired ◊ mixed interest ◊ deep pockets
Progress by next round of financing: ◊ alliance ◊ ship product ◊ revenue growth ◊ profits

Product/market risks

Market uncertainty: ◊ create market ◊ uncertain market ◊ proven market for this company
Competitive advantage: ◊ questionable ◊ many competitors ◊ few competitors ◊ no competition
Development risks: ◊ major hurdles ◊ uncertain key tasks ◊ timing only ◊ none
Technology position: ◊ none ◊ unproven ◊ unique ◊ unique, protected

them and fewer options for you. Most venture capitalists will investigate you thoroughly before they invest (see "Sizing up the risks: an investor's checklist," P. 17). They'll verify industry statistics, check references, and even hire consultants to validate the technology. They'll also try to get a feel for your organization by talking to employees. Their feedback is often objective, and it can be quite valuable.

I recommend that you deal with large venture capital firms that make early round investments. Big firms have succeeded for good reasons, and they can be more helpful to you. In principle, small firms can make decisions faster, but in practice, I have not found that to be so. My experience suggests you'll want to contact several firms and keep the discussions independent to create some degree of competition to help closure (see "Asking for money").

After you've made a deal for major funding to help your company grow, spend wisely and strive for profitability. That simple sentence encapsulates the personal discipline and the company culture you need to grow the business and provide return to your investors. Ultimately, higher valuation comes with earning power, and profit gives you the cash reserves and credibility to raise additional capital when you encounter a really important opportunity.

Naturally investors want to help you succeed, if you let them. They are invaluable resources — they can share their experience, introduce you to people, and give you credibility when you need to raise additional financing. If you include them in your decision making and share your successes and failures with them, they will feel involved and empathize with you. They may even be willing to help you when you're in trouble.

A personal note

It's hard to make good decisions when you're boxed in and forced to jump at the first opportunity that comes your way. That goes for choosing a job, a business idea, or an investor proposition. You'll want to give yourself breathing space and quality time to think through the issues and look at alternative scenarios. The importance of setting aside some readily accessible cash is an essential point for you to remember. This "mattress money" buys you time!

In my case, a small amount of savings changed my career. I was able to join a startup company just two years out of graduate school, partly because I could afford to take a one-third cut in salary and invest all my savings (a mere $6,000, about four months salary in 1970) to help satisfy the critical cash needs. I have seen people turn down wonderful opportunities because they have little savings and major commitments like a big mortgage. Joining a startup opportunity would jeopardize their family's security. Fair enough. But remember that setting aside some discretionary funds can afford you the luxury of taking risks that may lead to big rewards. □

Asking for money

In raising capital, you're asking investors to risk their money, a highly emotional event. As in all "selling" situations, you want to do everything possible to reduce the buyer's sense of risk and to differentiate yourself from others.

For example, a proper introduction adds credibility and keeps you from getting rejected out of hand. Be well prepared; try to understand a potential investor's situation and identify with his or her problems. Anticipate questions; make the investor comfortable with you. Make your presentation brief, interesting, and to the point. You must not only make in investor understand your proposition, you must minimize the investor's risk of being unable to answer questions raised by investment partners. Be open and truthful; evasions only heighten the sense of risk-taking. You must convey confidence, preferably with a willingness to risk some of your own assets in the business.

Be patient and deliberate because it takes time to make an investment derision, Due process has to occur. Keep the interest high and the dialog going. It wouldn't hurt to find competing investors. It's difficult to raise money, but from the investors' point of view, it's equally difficult to find a good opportunity.

Useful contacts:

National Venture Capital Association, 1655 North Fort Myer Drive, Ste. 700, Arlington, VA 22209; phone: (703) 351-5269, FAX: (703) 351-5268

Western Association of Venture Capitalists, 3000 Sand I fill Rd., Bldg1, Ste. 190, Menlo Park, CA 94025; phone: (415) 854-1322; directory available for $50